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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Pakistan: The Costs And Benefits Of The Union

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ER IM 70-24
March 1970

Copy No. 48

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
March 1970

INTELLIGENCE MEMORANDUM

Pakistan: The Costs And Benefits Of The Union

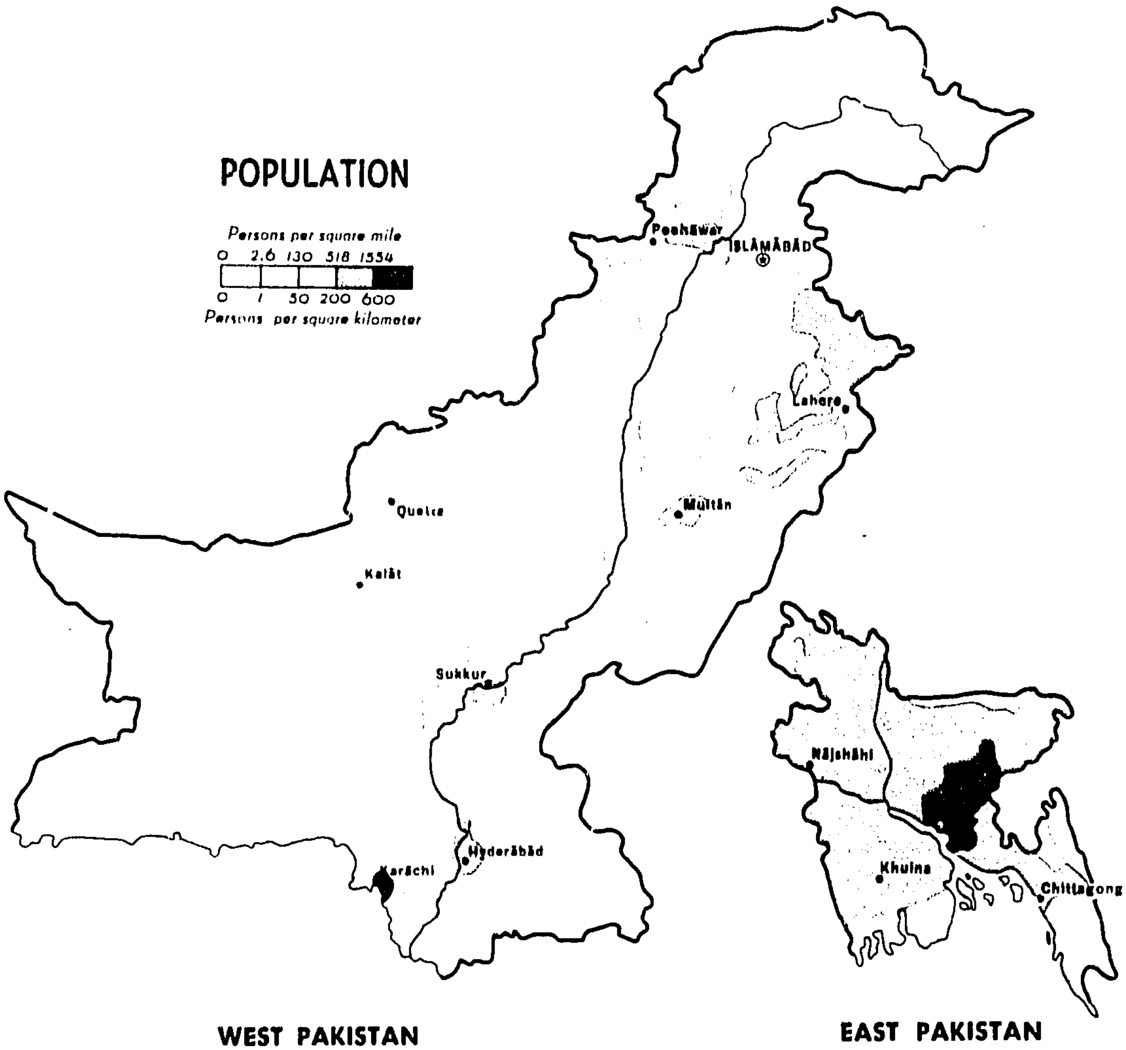
Introduction

East and West Pakistan, although united politically, have little in common except Islam, which was the chief basis for establishing the nation when the British partitioned India in 1947. They were then and are now socially, ethnically, and economically quite different. Since 1947, the East's economy has grown much slower than the West's and this has been the root of much of the agitation in the East in recent years.

East Pakistani leaders assert that the slow pace of development largely reflects central government discrimination against the East, and particularly, allocation of most of its resources to West Pakistan. They claim that most public and private investment, including foreign aid, has been funneled to the West and that even the East's foreign exchange earnings have been used to finance imports into the West wing.

This memorandum analyzes the reasons for the income disparity between East and West Pakistan. It assesses the resource bases of both wings, the development patterns, the economic impact of integrating the two geographically separated regions, and the role of the West-dominated central government in allocating available resources. In addition, the outlook for closing the income gap and its political implications are examined.

Note: This memorandum was produced solely by CIA. It was prepared by the Office of Economic Research and was coordinated with the Office of Current Intelligence and the Office of National Estimates.



East Pakistan has 15% of Pakistan's area and 55% of the population, with a density of more than 1,200 people per square mile - one of the world's highest. West Pakistan is sparsely settled, with a population density of only about 200 people per square mile.

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The Economic Setting and Partition

1. Prior to partition, what became East and West Pakistan were both relatively neglected regions of the Indian subcontinent, engaged principally in exchanging agricultural raw materials for the products of India's urban centers. There was almost no movement of goods or services between the east and west wings, and their exports consisted largely of cotton from the West and raw jute from the East. Both were appallingly poor, and per capita incomes probably were about the same.

2. Although regional living standards were similar at independence, the economic development potential was substantially more favorable in the West. West Pakistan inherited considerable infrastructure built during the British rule, including the Punjab rail network, while such facilities were almost non-existent in the East. Moreover, the West had a much greater reservoir of skills, know-how, and entrepreneurship upon which to develop an industrial sector. At independence, some 20% of the West Pakistanis lived in cities, compared with only 5% in the East. Because the West was relatively remote from Indian commercial centers, many small-scale privately owned firms had been established to service the infrastructure and the large military force stationed there. In contrast, almost all services needed in East Pakistan were supplied from nearby Calcutta, which is now in India.

3. The West's agricultural potential far exceeded that of the East. The Indus Basin irrigation works, built by the British in the 19th century, provided the Western farmer with a degree of water control unavailable in the East. Much less densely populated, Western rural regions had relatively large farms producing considerable amounts of goods for sale, and there was a large amount of acreage still available for tilling. Consequently, the farmer there was better off -- better able to borrow funds and to take advantage of new techniques. In East Pakistan, however, there had been little effort made to control water, and farmers were heavily dependent on unpredictable monsoons. This limitation combined with high population density resulted in small-scale farms capable of producing very little beyond the farmers' immediate needs. Moreover, there was little room left for

expanding output through using more acreage because almost all usable land was cultivated.

4. In addition to these inherited advantages, the West gained and the East lost from the communal violence between Hindu and Moslem that preceded and followed partition and led to substantial shifts of population. Most of East Pakistan's trade during the colonial period was controlled by Hindus who, following partition, fled to India, leaving the East without a trading class and bereft of entrepreneurial skills. West Pakistan, by contrast, was a haven for Muslim entrepreneurs fleeing India to their ethnic homeland. This shifting of skilled populations markedly improved the potential for developing the West's resource base and markedly worsened the already dim outlook for the East.

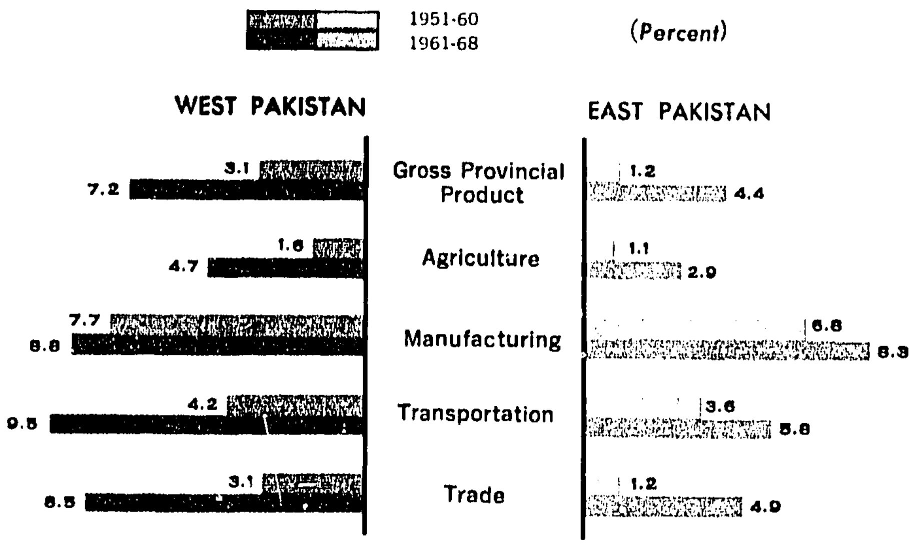
Economic Development Since Partition

5. During the 1950s, Pakistan's economic growth barely kept pace with the population increase -- about 2-1/2% per year -- and by the decade's end, per capita income was practically unchanged. Overall growth was inhibited by the political instability and the lack of interest and investment in agriculture. Output in this largest and most crucial sector rose on the average by less than 1-1/2% annually and thus failed to keep up with population growth. Economic growth would have been even slower had not industrial output been increasing rapidly -- about 8-1/2% annually -- in the process of developing production of goods previously supplied by India. Before partition, raw jute was shipped from East Pakistan to India where it was processed into manufactures, but the East has since established its own jute manufacturing facilities. Textile plants were set up in the West to replace Indian textiles.

6. West Pakistan, however, fared much better than did the East (see Figure 1). Manufacturing expanded at about the same rate in both wings, but because the base was larger in the West, industrialization there had a far greater impact. Moreover, the West's larger and better established service sector grew much faster. Locating the new Pakistani capital in the West meant a much more rapid growth of government services there in comparison with the

Figure 1

Average Annual Rates of Growth in East and West Pakistan



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East, and private services, including banking, shipping, and trade, were also mainly headquartered in the West where most of the wealthier businessmen and skilled workers resided. Consequently, per capita income in the West rose about 8% during the 1950s while in more agriculturally oriented East Pakistan it actually declined some 10%.

7. Following Ayub Khan's accession to power in 1958, economic growth accelerated sharply. Gross national product (GNP) grew 5% annually during 1961-69, double the rate of the previous decade. An extremely important factor was the political stability created by the military regime, but the major stimulus was agricultural expansion in both regions at rates triple those achieved during the 1950s. The signing of the Indus Water Treaty in

1960 funneled considerable foreign assistance into Pakistan as part of the settlement of this dispute with India. The government also increased its agricultural investment expenditures, instituted more favorable agricultural price policies, and liberalized imports of fertilizer, pumps, and other modern farm inputs. The expanded imports were greatly facilitated by a rapid rise in foreign aid receipts from about $1.5 billion during the 1950s to $5 billion in 1961-69. Although agriculture was the main growth determinant, it generated, along with foreign aid, an even more rapid growth in the manufacturing and service sectors.

8. Both regions did well during the 1960s considering their respective potentials. The East, with its more limited resources, was able to step up economic expansion above the rate achieved during the 1950s. But the more developed West grew even more rapidly. The West, receiving all the benefits from the massive Indus River scheme and better able to utilize modern agriculture technology, especially the new high yielding seeds (see Figure 2), grew at 7.2% annually while the East expanded at 4.4%.* The income gap thus continued to widen during the 1960s. Per capita income increased by 12% in East Pakistan and 40% in West Pakistan, and by 1969 it was about the same as in 1950 in the East but was 50% higher in the West.

Figure 2. New wheat strains at a West Pakistan agricultural experimental farm. Strains and agricultural practices have spread rapidly throughout the province.

9. Thus Pakistan enters the 1970s with a considerable income disparity between regions and with little chance of preventing a further spreading. Twenty-odd years after independence, East Pakistan still lacks the human, institutional, and physical resources

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for rapid economic growth in the foreseeable future. These constraints would still be binding even in the unlikely event that large amounts of foreign aid were received. The dominant agricultural sector will make little headway unless flood waters are controlled (see Figure 3), and at best this would take enormous capital and many years. Meanwhile, the region's land cannot support the existing population whose continuing rapid growth increasingly worsens the already very low quality of life with little likelihood of relief. Although expanding rapidly, the East's industrial and modern service sectors are still very small. West Pakistan, on the other hand, is favorably disposed to sustain growth. Irrigated areas are continually being enlarged and improved, and the farmers with their relatively large farms and capital can take advantage of the improved water supply. Most important, the region has a dynamic cadre of entrepreneurs and a relatively well-trained labor force. Rapid economic growth in the West would, of course, be threatened in the event of political instability or the placing of extensive government curbs on the private sector in the hope of removing income disparities between and within regions.

Government Policy

10. The central government took little cognizance of the incipient regional income disparities during the 1950s. The gap was small, with both regions being about equally poor almost to the end of the decade, and the central government was preoccupied by political problems and the dislocations caused by partition. Moreover, the government's revenues from both local and foreign sources were small.

11. During the 1960s, however, Rawalpindi took increasing steps to right imbalances between the two regions which were then becoming increasingly apparent. A growing dissatisfaction in the East forced the central government to heed the problem, and considerably more foreign aid combined with an improved economic situation allowed the government more latitude in dealing with it. Deliberate efforts were made to increase East Pakistan's share of public investment. Excluding the Indus Basin scheme, public investment in East Pakistan since 1961 has risen much faster than in the West, and since 1967 the East's share of total investment actually has been greater. In 1969, even when the

Figure 3

East Pakistan in the dry season. The circular structures are mounds of earth to raise homes above the annual floods.

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Indus Basin is included, East Pakistan received almost as much public investment funds as West Pakistan (see Figure 4).

12. The central government has also attempted to increase private investment in the East more rapidly than in the West. Potential investors in the East were offered such inducements as longer tax holidays, lower tariffs, and lower requirements for government loans than were allowed in the West. For example, tax holidays of four to six years are allowed in East Pakistan, compared with two to four years in West Pakistan. Despite these efforts, however, most large investors continued to shun East Pakistan whose share of total private investment remained at about 20% during 1964-68 (see Figure 5). Opportunities for investment remained much greater in the more dynamic western region, and the government incentives for investment in the East did not offset the better profit potential in the West. Most investors are from West Pakistan who prefer to invest nearby where they have better control. It is more than 1,000 miles between Lahore and Dacca. There is also the nagging concern that the East may someday break away and that West Pakistanis would be unable to repatriate profits or would lose their investments entirely.

Interregional Trade

13. Dismembering the Indian subcontinent into Muslim Pakistan and Hindu India disrupted old economic patterns and created opportunities for new patterns. Economic ties between the two countries were progressively undone, and by the mid-1950s those remaining were only of minor importance. Meanwhile, the two geographically separated areas of Pakistan began to integrate economically.

14. Interregional trade grew as both sides took advantage of a national market protected by common barriers erected against the outside world. This interchange was considerably assisted by the differences in the natural resource base each possessed. East Pakistan's most important interregional basic commodity export was tea, while cotton, wheat, and oil seeds were the major items moving from the West to the East (see Figure 6). The manufactures

Figure 4

Public Investment in East and West Pakistan

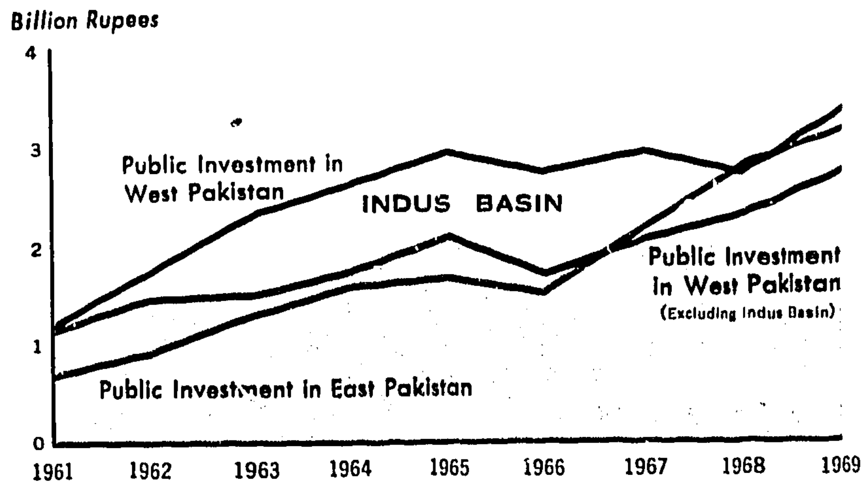

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Figure 5

Private Investment in East and West Pakistan

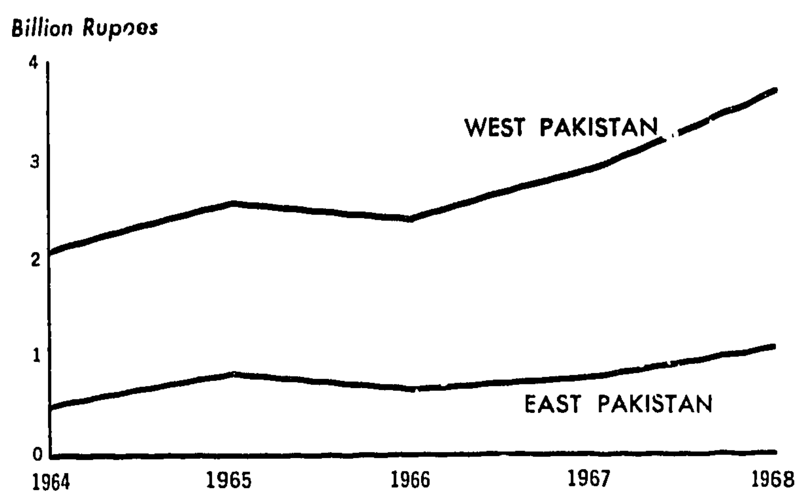

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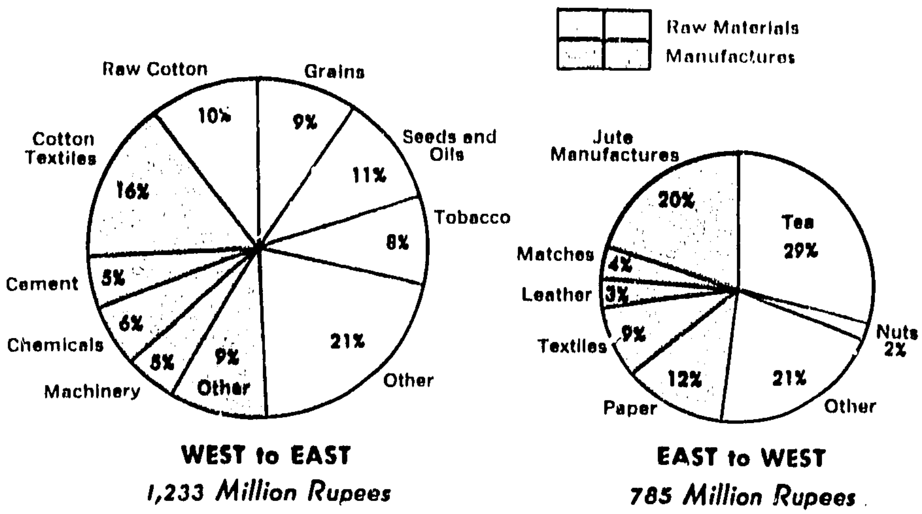
Figure 6

Pakistan: Composition of Interregional Trade, 1968



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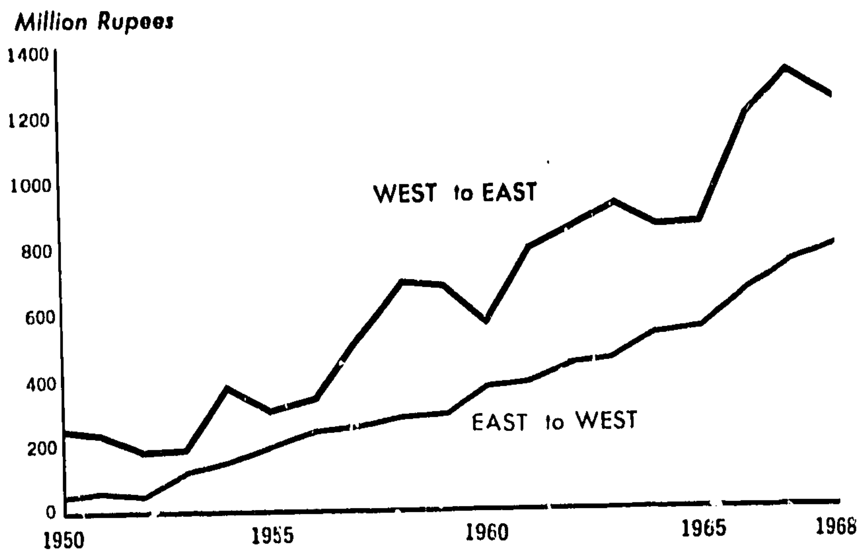
exchanged were largely those produced from each region's available raw materials -- textiles going to the East and jute products and paper going to the West.

15. Trade between the regions rose faster than the nation's foreign trade, about 12% and 6%, respectively, between 1955 and 1968. The flow of goods westward increased more rapidly than the flow eastward, but West Pakistan's interregional exports in 1968 were still about 60% greater than those of the East (see Figure 7). The most dynamic increase in interregional trade for both East and West Pakistan took place in manufactures. By 1968, about one-half of the interregional trade was in manufactures, compared with about one-third in 1960 and almost none at partition.

Figure 7

Pakistan: Trends in Interregional Trade (cif)



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Financial Flows*

16. West Pakistan for two decades has had balance-of-payments deficits with the outside world while the East has achieved surpluses. The East's better foreign position is mainly due to its larger volume of exports. At partition, both regions had trade surpluses, but Western exports fell during the 1950s, largely because cotton -- once a major export -- was used increasingly to produce textiles for domestic markets. Although the East used an increasing portion of its raw jute locally to produce jute manufactures, it was able to market much of this new production abroad. During the 1960s,

* *For a discussion of the methodology used to derive financial flows, see the Appendix.*

East Pakistan's foreign exports were some 20% higher than those of the West. As a result, the East had a cumulative basic balance-of-payments surplus during 1961-68 of about 4.8 billion rupees (see the table), while the West had a deficit of the same magnitude. With Pakistan's net reserve position practically unchanged, it is clear that East Pakistan's surplus was used to offset the West's deficit.

17. Interregional transactions were the reverse of the foreign movements; the East ran deficits while the West had surpluses. Because initially the West had a large surplus in its trade with the East, the absolute size of its surplus increased despite the fact that the East's interregional exports were rising faster. Net service payments to the West for such items as transportation and banking grew along with the trade. The East paid the West for these goods and services mainly with funds it earned in transactions with the rest of the world, with the remainder financed by the West. During the 1950s, while there was probably no large net interregional movement of central government funds, there was a flow of private capital from the West to the East to develop jute manufacturing or other businesses. The 1960s saw the central government spending roughly 3 billion rupees more in domestically obtained capital in the East than it raised there. However, a net flow of private funds (capital, business earnings, transfer payments) from the East to the West partly offset the central government's efforts to shift resources to the East. Although there was probably a movement of private capital from the West to the East to establish new facilities, remittances of profits back to the West were even greater.

Costs and Benefits of the Union

18. Both East and West Pakistan benefit economically from their political union. Behind protective tariff walls each region has rapidly expanded its production of goods for the national market. The West Pakistani textile industry, for example, by supplying the East Pakistan as well as the West Pakistan market, has probably been able to reduce its unit production costs. Each region also has been able to sell goods they otherwise would have a hard time disposing of in world markets, as in the case of East Pakistan's low-grade tea.

Pakistani Balance of Payments a/
Cumulative 1961-68

	Billion Rupees	
	East	West
Foreign balance		
Current account	-1.9	-17.8
Goods	-0.2	-15.0
Exports (f.o.b.)	10.0	8.4
Imports (f.o.b.)	-10.2	-23.4
Services	-1.7	-2.8
Capital account	6.7	13.0
Foreign aid	7.1	14.3
Foreign private investment	0.2	0.5
Debt servicing	-1.0	-2.3
Monetary movements and errors and omissions	0.5	0.6
Changes in reserves	-0.1	-0.1
Total	*4.8*	*-4.8*
Interregional balance		
Goods	-2.8	2.8
Exports (f.o.b.)	3.5	6.3
Imports (f.o.b.)	-6.3	-3.5
Private sector services (net)	-3.0	3.0
Government financial flows	3.0	-3.0
Private financial flows b/	-2.0	2.0
Total	*-4.8*	*4.8*

a. For estimating procedure, see the Appendix.
b. Including flows of private investments and profit remittances.

19. Without internal barriers, private capital moved freely between regions seeking the most profitable opportunities. Although most opportunities and capital were in the West, investment funds also flowed East because the region lacked sufficient capital even for its more limited opportunities. The East thus gained sorely needed capital and skills while West Pakistani businessmen obtained additional profits. East Pakistan's jute manufacturing industry is the prime example of investment from West Pakistan. With a paucity of small-scale entrepreneurs, East Pakistan also benefited from the large number of West Pakistanis who function as traders and provide services such as banking and transport. Although boosting economic growth in both regions, the union did not prevent a growing income disparity between them, because the growth in each region that can be attributed to economic union is small compared to more basic factors such as agricultural and entrepreneurial resources.

Costs and Benefits of Dissolving the Union

20. A breakup of the union would on balance cost both regions. Some of the goods traded regionally could be bought more cheaply abroad, but each region also receives more from its interregional exports than if it sold them abroad. On balance, some net gain in the overall terms of trade probably would accrue to the East, which buys more than it sells in interregional trade. On the other hand, the total volume of trade would probably fall because some of the products the East sells to the West may be unmarketable abroad. The West would suffer an even greater drop in trade volume for the same reason.

21. It is impossible to estimate, however, whether either region's import capacity would rise or fall in the event of dissolution. The most important determinant of the change in import capacity would be the availability of foreign aid.

22. For the West, dissolution of the union might bring difficult financial problems, but in the long term, growth prospects would remain favorable because of the area's endowment in entrepreneurial talent and agricultural resources. For the East, however, growth prospects would be seriously diminished, even if foreign exchange resources were plentiful. If

dissolution occurred, there would be a high probability of a flight of West Pakistani entrepreneurial and technical talent from East Pakistan. Since West Pakistanis virtually run the modern economic sector of East Pakistan, this flight would be extremely disruptive and the loss irreplaceable for the foreseeable future.

Conclusions

23. The Pakistan political union benefits economically both the East and the West. Each region rapidly expanded its production of goods for the combined market, a process greatly assisted by tariff walls and by the ability to specialize because of diverse agricultural resources. The flow of capital and entrepreneurs from the West benefits the East which sorely lacks these development ingredients. On the other hand, the West obtains relatively large profits from investments in the East.

24. Although the union has fostered economic growth in both regions, the income disparity has grown. This gap is increasing because of marked basic differences in resources. The East suffers from severe population pressure and lacks human skills as well as adequate water control. Little progress is possible without a major and enormously expensive flood control program or a mass exodus of population. Industrial development is hampered by the lack of any significant local entrepreneurial class.

25. The dryer West, on the other hand, has an extensive water containment system, and its farmers, because they have capital and relatively large tracts, are able to take advantage of new technology such as the "miracle" seeds. The West's urban areas are far larger than the East's, and the West has a relatively large group of entrepreneurs with capital to take advantage of opportunities in urban centers. In addition, the West has benefited from the massive Indus Water scheme, which has allowed the region to achieve self-sufficiency in foodgrains.

26. The appreciable differences in growth potential between regions have negated Rawalpindi's efforts to close the income gap. At least since the

early 1960s, the central government has rapidly increased public investments in the East and has offered strong inducements to private investors in that region. The eastward movement of public funds, although large in terms of local funds available, can hardly begin to solve East Pakistan's basic problems. The East's share of total private investment has failed to increase because most investment opportunities are in West Pakistan and because Westerners are uncertain of the East's future stability. Even in the unlikely event the East obtained a massive foreign-financed water control system, it would be many years before such an effort would materially affect growth prospects.

27. President Yahya's announcement in November 1969 that the constituent assembly to form a new constitution will be elected on a one-man one-vote basis assures an East Pakistani majority. The outlook is for political discord between East and West to continue, however. There is even a possibility of an eventual breakup. Unable to improve much economically, the East will doubtless continue to blame its plight on domination by West Pakistani business interests whatever steps are taken by Western leaders to assist the East. If the East does gain control in Rawalpindi, increased resources may be diverted from the West in the hope of spurring development of the East. Such conditions could lead to efforts by West Pakistani leaders to regain control or to secede. Whoever precipitates any secessionist move, both sides would be hurt as the gains achieved through the free interregional flow of goods, services, and capital would largely be lost. The West, however, would soon recover, but the East would face an even slower growth rate than at present.

APPENDIX

Methodology

Only trade data were available for estimating the balance of payments of both East and West Pakistan with the rest of the world and with each other. Other foreign transactions of each region are estimated from data available on Pakistan as a whole. Interregional flows other than trade are estimated [redacted] other than balance-of-payments 25X1 data. The estimates, in many cases, are subject to a high degree of error, and the various flows are only rough orders of magnitude. To minimize errors which may appear in annual calculations, the data are for 1961-68. A detailed explanation is presented below.

Foreign Flows

The foreign goods and services movements are from the IMF balance-of-payments records for Pakistan. They are allocated regionally in the same ratio as each region's foreign trade as reported by the Pakistani government.

The foreign capital flows from the IMF data are divided between East and West on a one-third and two-thirds basis, respectively. This relationship is about the same as the two regions' modern monetized economies -- such as industry's contribution to GNP and the money supply -- bear to each other. In general, the results agree with the estimates obtained using other methods and appear reasonable.

Interregional Flows

The interregional trade balances are from Pakistani government statistics adjusted from a c.i.f. to an f.o.b. basis. Each item is reduced by 20%, the same portion of freight and insurance in Pakistan's foreign imports.

Interregional private sector services are composed of two elements: (1) the transportation cost and other expenses involved with interregional trade; and (2) East Pakistani payments for Western banking, insurance, and other services. The first

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is the difference between interregional trade on a c.i.f. and f.o.b. basis with 90% going to the West and 10% to the East. Almost all interregional freight and freight insurance is handled by West Pakistani firms. The second is assumed to approximate half of the first on a net basis. Service firms in the East are owned mainly by West Pakistanis.

Interregional government financial flows are derived from budgets. Sufficient information is available to determine that the central government's current revenues and expenditures in East Pakistan approximately balance. Public capital transfers are estimated by subtracting from public capital expenditures in East Pakistan, the estimated share of the capital which originated in the province. It is assumed that two-thirds of the capital raised is from the West and one-third from the East.

Interregional private financial flows are residual. They include unilateral transfers, profit remittances, long-term and short-term autonomous capital movements, and balancing changes in the money supply. There is no information on any of these individual categories.

Some distortion of balance of payments occurs because international flows are converted to rupees at the considerably overvalued official exchange rate. Two statistical problems emerge as a result. The first is a misrepresentation of the relationship between international and interregional movements. If a realistic exchange rate is used, then foreign trade would be relatively more important compared to interregional trade. The second is an understatement of the value of interregional private financial flows which is residual from other estimates and is the balancing item. With a more realistic exchange rate, the total foreign balance would be larger, and because foreign and interregional accounts necessarily must balance, the latter would also be larger. All interregional flows would remain the same except the balancing item, which would increase. If, for example, the rupee is overvalued by 50%, the private financial flows account would amount to about 4 billion rupees instead of 2 billion rupees shown in the table.